

# Italy Is Running Out of Time to Leave the Euro

By **Marcello Minenna**

There's been sharp selling pressure on eurozone government bonds lately, led by Italy and concerns about its future in the eurozone. By the beginning of the year Italian government yields rose 40 basis points over German Bunds, a 25% increase. The main pro-European Union party, Matteo Renzi's Democrats, are on the verge of a breakup. Euroskeptic parties are on the rise. A banking crisis and a renewed push for government-spending cuts and tax increases, all in the name of austerity, will only increase the likelihood that anti-euro parties will win the coming general election.

Yet too few commentators are focusing on whether Italexit would be practically possible. As of right now, the costs associated with Italexit would outweigh the supposed benefits by €40 billion (\$42.38 billion). This is according to a study I recently conducted with Antonio Guglielmi of Mediobanca Securities and based on the plausible assumption that Italy's central bank repays the bonds purchased in euros under the European Central Bank's quantitative-easing program. The bill would become even steeper as time passes.

No one knows much about the process by which Italy might leave the eurozone and adopt a new lira. A cascade of effects could be ignited in at least three different ways: via the trade balance, the financial accounts and the redenomination of debt through a widespread application of the *lex monetæ* principle.

Regarding international trade, the devaluation of the lira by an unknown amount (estimates range from a 50% devaluation versus the euro to a 1% revaluation) would intersect with President Trump's trade policy, with uncertain effects on Italian exports. A U.S. protectionist measure toward Europe or a sharp devaluation of the dollar could offset the eventual competitiveness benefits of a weaker lira.

Other financial costs have re-

cently come into view, among the biggest of which would be Italy's Target2 deficit. Target2 is the eurozone's system for clearing transactions among central banks and other financial institutions. Countries with capital outflows, such as Italy, post Target2 deficits representing money owed by their central banks to other eurozone central banks, while countries with capital inflows have surpluses in the system.

Italy's Target2 deficit currently stands at around €364 billion. It has grown in recent years as investors use cash provided by the Italian central bank under the eurozone's QE program to invest outside of the country and hedge against the risk of assets being redenominated in liras. This can continue indefinitely, so long as Italy remains in the eurozone, on the theory that at some point capital flows could reverse and the deficit could net out.

However, Mario Draghi, the ECB president, warned in January that a country leaving the eurozone would be expected to first settle its Target2 bill. Amid the other instabilities caused by an Italexit, this would be crippling for Italy.

Proponents of Italexit have also yet to fully consider whether, or how, Italy outside of the eurozone could use *lex monetæ* to redenominate its debts. In theory, a government has the right to redenominate local debts in the local currency. But there are limits to this principle.

An analysis of Italy's €1.9 trillion of government bonds outstanding suggests that only about half of that debt was issued under Italian national law and thus could be redenominated. A negligible share would remain in euros, as those bonds were issued under foreign laws.

The bigger problem would lie in the other half of government debt, which is tied to collective-action clauses, or CACs, introduced in the eurozone after 2012. These measures, intended to avoid the disorder witnessed in the Greek, Spanish, Portuguese and other crises, allow a qualified minority of 25% of bondholders to block a redenomination.

Since the ECB has increased its

bond holdings under its QE program, as time passes it becomes more likely that the ECB would hold enough of any given bond issue to block a redenomination. The ECB already has increased the proportion of a single bond issue it will buy to 33% from 25%, implying it was already hitting that limit in some cases. And as older debts are rolled over, the value of Italian bonds subject to CACs increases steadily as well. According to our estimates, by 2022 all Italian sovereign debt will be subject to CACs, impeding exercise of *lex monetæ* to redenominate.

These results color any calculation of the possible benefits of Italexit. As of today, Italy could reduce its debt burden by at most €57 billion even if the central bank were to redenominate debts held by the ECB, assuming a 30% devaluation of the new lira versus the euro and accounting for the current quantity of euro debt that could not be redenominated (and the costs of paying that debt in cheaper lira).

That savings, already small relative to Italy's debt burden and compared to the dramatic economic disruption that would follow an Italexit, will continue to shrink rapidly as more debt becomes harder to redenominate. If politicians aren't prepared to leave the eurozone right now, they should instead focus on boosting Italian competitiveness and growth in other ways.

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**The longer Rome skirts 'Italexit,' the costlier it becomes. Drop that idea and start reforms instead.**